The **Agenda** 2004

Are insurance companies genetically defective?

Another stealth tax
- but this time it's a rebate?

When all else fails, stop competing

Just educating the consumer won't work

The Actuarial Profession
making financial sense of the future

The Agenda 2004

A MATTER OF POLICY

This year, The Agenda invited members of the actuarial profession to take a look at public policy issues affecting the financial services industry. Starting where every human being starts, in the genes, David Paul questions the basic data life assurers demand from policyholders and asks whether new laws could, or should, change all that (see page 2).

On the financial front, Jon Palin asks whether companies could be giving their shareholders a more tax efficient return on their investment. He says the answer is "yes" and, on page 4, he explains how, predicting that the Government's policy initiatives will give finance directors a shove in the right direction – finally bringing practice into line with theory.

Another inconsistency between investment theory and practice is examined by John Shuttleworth (page 6). Looking at the question from the retail investor's perspective, he argues that the subject is too complicated for consumers to understand and challenges us finally to face up to the fact. Jeremy Goford says that competition is partly to blame (page 8) and anticipates the OFT's review of the effects of financial services legislation on competition.

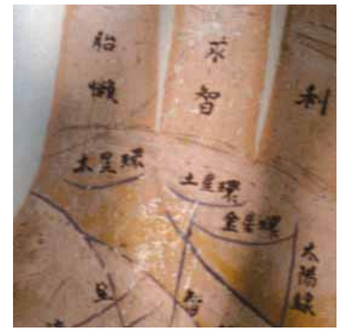
With the stock markets having bounced up (a little) from the lows they hit last Spring, we take advantage of the less panicky environment to ask whether life offices and pension funds could be made more secure. The answers are surprisingly different. Nigel Masters says (page 10) there is scope to build more security into life companies, if customers – and managers – are prepared to pay the price. But maybe not so for pension funds. On page 12, I suggest that pension funds are not as badly off as some might think, although there may now be a time bomb under the sponsoring employers .

The Agenda concludes by turning its spotlight on the actuarial profession itself (page 14). Tom Ross looks at the process for setting actuarial standards and finds it wanting in today's environment.

Contributors to The Agenda are all members of The Actuarial Profession, expressing their personal views.

Simon Carne
Editor, The Agenda

January 2004



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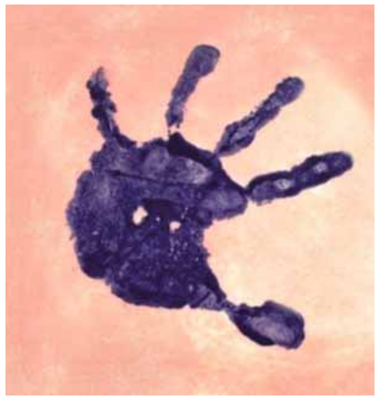
Contents

Are insurance companies genetically

defective?

***David Paul** says the moratorium on genetic testing has uncovered a much more fundamental issue – should insurers be permitted to do **any** medical screening?*



When someone takes out a life assurance policy, especially a large policy, it is not unusual to be required to undergo a medical exam. The reason is obvious: if there were no medical check, the terminally ill would take out very large policies shortly before their moment of truth.

But if that is the only reason – to stop people from using knowledge of their own ill-health to gain an unfair advantage – why do insurers also test for illnesses that are as yet unknown to the policy applicant? The reality is that insurers' medical checks are designed to identify the unknowingly unhealthy, as well as those who know of their illnesses. Using this information, insurers can vary terms to match risks – exactly what economics predicts a profit-maximising insurer should do in a competitive market place.

Until recently, this state of affairs was accepted – perhaps not by those who were unlucky enough to discover they had a hitherto unknown health problem – but by society at large. If there was a statistical justification for charging special terms, conventional wisdom was that the insurer should be permitted to do so.

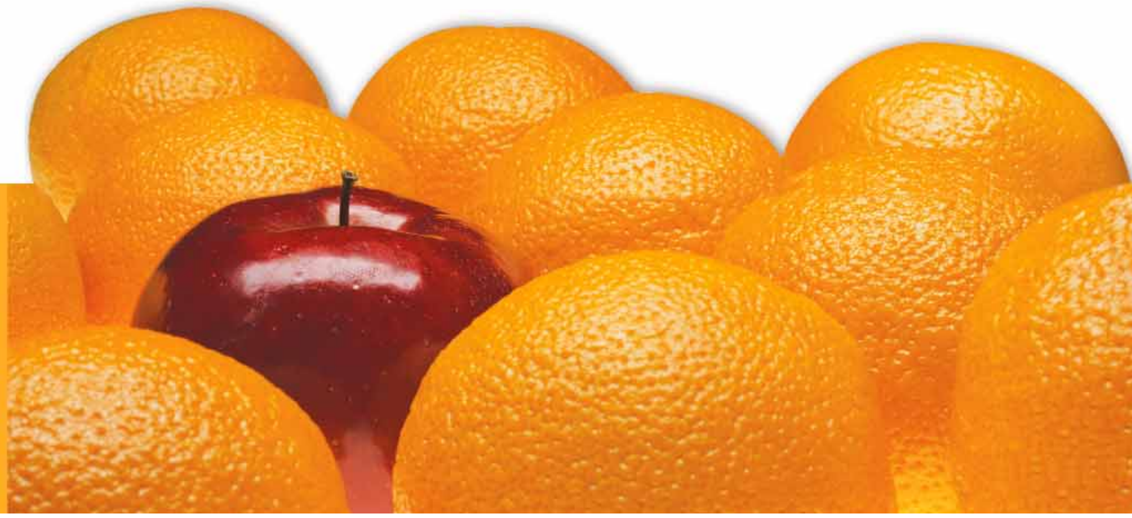
But, then, along came genetic testing and the possibility (whether it be science fact or science fiction) that all manner of illnesses could be uncovered years before they struck. And, if not the certainty of the illness, at least the genetic pre-disposition to it – in other words, an increased statistical likelihood which would justify the insurer imposing more costly terms.

Suddenly all the talk was of a genetic underclass, a group for whom insurance would be unavailable, based on the results of genetic information, the reliability of which was still uncertain. A moratorium has been agreed between Government and the Association of British Insurers, whereby no genetic information will be used for insurance pricing until 2006 (except for policies over £½ million) to allow time for further reflection.

But why stop there? If genetic testing is unacceptable, why allow insurers to ask about family histories and then base premiums on the information that reveals? At least a genetic test has the advantage that it doesn't depend on the policy applicant's knowledge or recollection of family history. Serious questions are now being asked. Just how reliable are the interpretations of family histories that insurers have been using for many years? Some say that elements of the insurer's guidance manuals are based on little more than old wives' tales.

Harsh criticism, and probably unjustified. But, interestingly, the Disability Discrimination Act 1995 allows insurers to discriminate only if there is "relevant and reliable data" to justify it. How long before someone tests an insurer's "data" to see if they stand up to legal scrutiny?

Even more interestingly, perhaps, the corresponding legislation in some parts of continental Europe bans differential charging irrespective of statistical validation. So how long before the statistical defence is challenged in the UK? Bearing in mind that the EU is calling into question the acceptability of differential premiums for men and women – on policy grounds, regardless of the statistical justification for differential charging – perhaps not long at all.



Another stealth tax - but this time

it's a rebate?

*Has Government policy on pension funds triggered an unexpected £5 billion pa saving for investors? **Jon Palin** thinks so.*

Pension plan portfolios are puzzling. In the UK final salary plans hold more than £300 billion of equities, but finance theorists argue that tax and other considerations show they should not hold any. And with few notable exceptions companies are prepared to leave their pension plans in deficit. Last year's policy announcements by the Government may change all this.

The biggest impact of pension fund asset returns is on the shareholders of the sponsoring company. Good returns mean they win through lower contributions to the fund; bad returns mean they lose through higher contributions. They are exposed to pension fund assets as if they held them directly. Shareholders can arrange their own portfolios to get the overall return they want. So why is the fund's asset allocation important? The main answer is tax.

A typical investor pays less tax on equities than on bonds, so it makes sense to try to satisfy the shareholders' equity desires through personal holdings and leave the bonds to be held through the pension fund. This way, investors can hold more equities directly, get the same overall returns, and save on tax. Alternatively moving the pension fund to bonds saves tax by letting the company be more highly leveraged while giving the shareholders the same return. In this way switching the fund from equities to bonds enables tax savings of over 1% of asset value each year. Further savings from the lower costs of running the portfolio mean a total saving of £5 billion each year – without otherwise changing shareholder returns.

None of this depends on the nature of the pensions, but by a happy coincidence bond investment provides a good match for the liabilities. Bonds and pensions both provide well-defined cash flows over the long term with a high but not perfect degree of security. So holding bonds not only saves money, it also provides security for pensioners.

Last year, the Government introduced a regulatory change requiring solvent companies to make good any deficit before walking away. Previously a company could leave scheme members with a deficit, so the shareholder gained from good returns and only lost a little from bad returns. For weak companies this might have outweighed the tax benefits of bonds. But last year's change made the case for bond investment even stronger.

The Government also proposed the Pension Protection Fund. This will protect pensioners if their employer becomes insolvent. To do this it will charge an annual levy on employers – speculation suggests this might be a flat 1% of the scheme's deficit.

Since pensions and bonds are similar, companies have always faced a choice between making good a pension deficit or paying down their own borrowings. The best action depends on the cost of the deficit, the cost of the debt, and the tax position. For strong companies it makes sense to issue bonds and use the proceeds to remove their pension deficit. In future, the extra cost of the protection fund premium will mean that borrowing to fund the pension plan will make sense for more companies.

But a standard charge for all companies will not be enough to persuade weaker companies to act. If the government wants weak companies to clear their pension deficits, it needs the protection fund to charge a higher levy for weaker companies. Without this, weaker companies will not have an incentive to fund their pension schemes.

The Government promised increased security for members. This may have the welcome side effect of pushing pension funds towards bonds, so that shareholders gain as well – at the expense of the taxman.

Just educating the consumer

won’t work

People should stop pretending that personal investment is simple. ***John Shuttleworth*** *explains why.*

Imagine your reaction if someone offered you a ride on a giant ball hurtling through space, with you strapped to the outside, spinning at 1,000 miles per hour. But what if they called it Earth (and offered to unstrap you)? Personal investment theory contains lines of thought just as unobvious.

Basics: most individual investors’ objective can be simply put: it is to optimise their spend on goods and services over their lifetime. To do this, the investor has four assets: their future state pension, any future inheritance, their investment portfolio, and what for most people is the most important, their human capital (a fancy name for earnings from all employments before retirement). Human capital falls with age, is impaired by booze, and can be enhanced by education. Most people’s human capital is bond-like: salaries are paid monthly and are correlated with inflation. Most people’s spend on goods and services is also bond-like; it can be replicated, more or less, by a portfolio of inflation-linked bonds.

Equities, finance theory teaches us, must have a higher expected return than bonds – to compensate for their greater risk. Equities go up and down; and sometimes they stay down for longer than the investor can hold his breath. Do the maths. Equities get riskier the longer they are held. It is a fallacy that time diversifies risk. In fact, the volatility of an equity investment’s end-value increases the longer the investor’s time-horizon. The reason for this is simple – the long-term investor has more time to encounter stock market crashes.

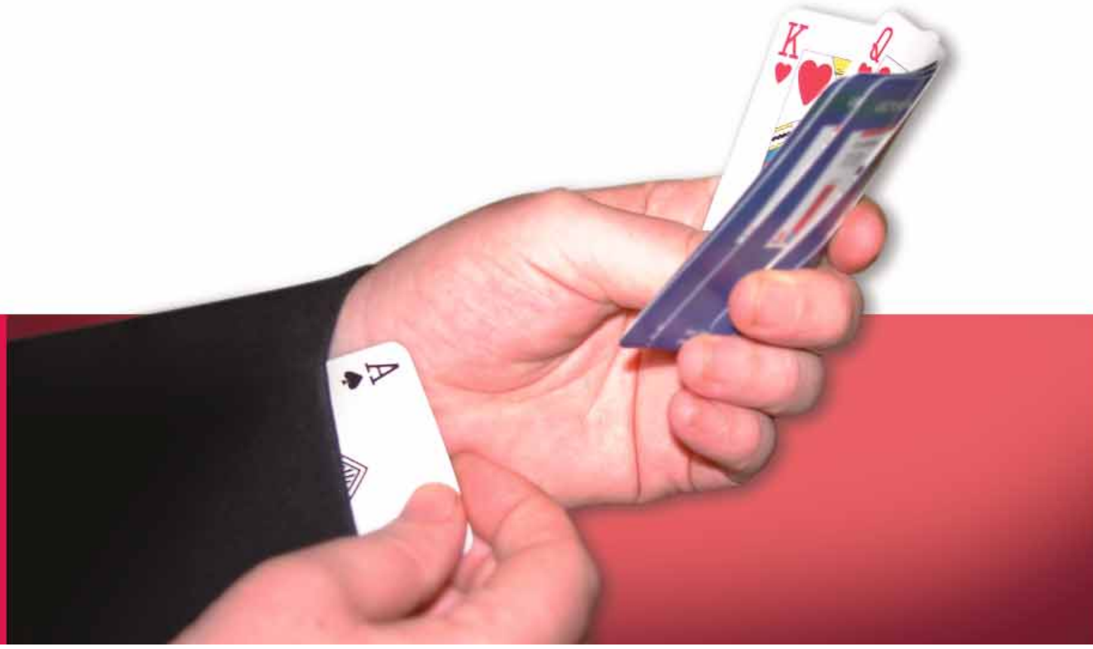
Most people have a "must have" level of retirement income below which they cannot risk falling. It follows that every investor should hold a portfolio of the lowest risk investment (inflation-linked bonds) to supplement their state pension to this bare minimum. Beyond this point the choice of mix of bonds and risky investments (such as equities) is anything but obvious. There are just too many factors to do more than generalise. The people who can afford to take more risk in their investment portfolio include those who are young, those who are prepared to delay their retirement, and those who are wealthy.

Whether equities are bought first and bonds second, or vice versa, the expected amount of money at the end is the same. The numbers do not lie. Hmm.

So why the rule of thumb that the investor should cut their equity holdings as they age? It’s because our (bond-like) human capital falls in value as we grow older, and so we need more actual bonds to maintain the overall desired risk level that we’re comfortable with. And we don’t want surprises near retirement. We need time to accommodate our standard of living to our wealth (or lack of it).

British investors have been slow to understand the importance of diversifying their equity portfolios. This is curious, given that Britain has for three centuries been the premier trading nation in the world. Equities are weakly correlated with an investor’s spend on goods and services. An equity portfolio should therefore be diversified: by industry and by economy; and stock-specific risk should be minimised. This suggests an equity benchmark that is global, not biased to constituents of the FTSE All-Share.

Anyone who tells you that personal finance is easy has got it wrong. The immensity of the task of educating our children should not be underestimated.



When all else fails,

stop competing

***Jeremy Goford** asks whether competition in financial services is part of the problem or part of the solution.*

From the moment New Labour arrived in power, they legislated to make anti-competitive behaviour an offence – something they are learning in schools these days, with the Eton and Winchester Bursars currently having their essays graded by the OFT. They legislated again last year to make the punishment fit the crime with prison sentences for cartel operators.

But can we have too much competition? Just look at the financial services industry. It is heavily regulated, with the regulatory touch getting heavier by the day and the coverage getting wider almost by the minute (mortgages and general insurance, to name two recent examples). Is this being done for the usual pro-competitive reason – to keep outrageous monopolies at bay? Most assuredly not. Financial regulation exists to protect consumers from overly competitive salesmen whose eagerness to meet their targets in a tough marketplace often leads them to take unfair advantage of the ill-informed buyer.

Economists call this imbalance of negotiating power "information asymmetry." In everyday parlance its abuse is known as mis-selling. Whatever it's called, it is widely attributed to companies knowing more than consumers.

The usual response to the imbalance of negotiating power is to aim to give consumers more knowledge. But what if that simply isn't feasible? When the (now former) chairman of the Financial Services Authority openly admits to having taken out an endowment mortgage – on three separate occasions – but now acknowledges that using equity-based saving as a match for a fixed interest debt was perhaps not the wisest of moves, you have to ask whether any of us really knows anything.

Actually, we know quite a lot, but it may not be very helpful. Most of all, we know that, with hindsight, one of the most popular forms of investment of the 1980s and 1990s has turned out to have unfortunate results for those whose policies (and their mortgages) are maturing in the early 2000s. If mis-selling was determined with hindsight, based on investment outturns, we'd have the wretched sellers bang to rights. But few people would dare sell an investment product ever again.

We also know that competition leads to innovation: new products, new services and new ways of delivering those services – all expected to benefit the consumer. But when the underlying product is essentially the same – gas molecules and electrons, for example, don't change according to the supplier – the innovative side of competition tends to emerge through ever more complicated charging structures. That's just another example of the more knowledgeable supplier taking advantage of the less knowledgeable consumer. No one who has the consumers' interests at heart wants to see a return to the days of the monopoly utilities, although some would welcome a return of the good old Directory Enquiries.

When the insurers tried to dampen some of the adverse incentives of their salesmen by restricting commission rates above a certain level, the practice was banned as anti-competitive. What then should one make of the 1% price cap imposed by the Treasury on stakeholder and Sandler products? The cap doesn't reduce the information asymmetry, because financial advisers can't be remunerated within the permitted charge. It doesn't increase competition – it does the opposite – because few providers will survive within those terms. Whether intentional or not, the price cap is effectively an announcement that competitive forces cannot be relied upon in the savings market.

Interestingly, at the end of 2003, the Treasury announced a review of the Financial Services & Markets Act, including a role for the Office of Fair Trading examining the effects of the act on competition.

Jeremy Goford is President of the Institute of Actuaries

It's the stock market

stupid- part I

The past three years have been a close-run thing for some insurers. ***Nigel Masters*** *asks whether there's a better way.*

Life companies are required to hold enough capital to be able to withstand a 25% drop in the stock market. That's an FSA rule. So when the stock market fell 50% over the first three years of the millennium and companies survived, you would think that everyone would have been mightily relieved.

Unfortunately, that's not human nature. Forget what the rules say. Insurance companies hold our money and our future prosperity in their hands. Insurance companies just aren't supposed to go bust. Period.

Well, what if that were true? If you put enough capital into the company, it might happen. But it would be very expensive. And, one way or another, it's the policyholders who will have to pay: up front, through higher premiums or, later on, through lower bonuses, higher management fees or whatever. Shareholders can help out (in non-mutual companies), by pumping in extra capital, but only if they can get an increased return later on. And that has to come out of policyholders' returns, however much one would like it otherwise.

But there is an alternative. We could look at life companies in the same way that we look at other industries. Those offering a higher quality should be able to capture the benefits through charging more for their product. The difficulty with this approach is, of course, that the quality of the life assurance product isn't finally known until years after the price has been fixed.

Active and open risk management may be the answer. Highly rated companies could do more to behave like they deserved their credit rating – for example, the higher the credit rating, the more closely the assets need to match the liabilities.

Companies with lower security ratings inevitably represent a bigger risk to their investors. The Equitable pared its capital to the minimum, opting to distribute as much surplus as possible through higher bonuses to policyholders. It wasn't a secret. Quite the reverse: it was part of the company's marketing strategy. Although one has to ask whether it was reasonable to expect the policyholders – many of them lawyers, accountants and other professionals – to understand the implications.

It's 15 years since companies were prohibited from basing bonus rate projections on past outturns. Instead, projections had to be based on assumed rates of return that were standard across the industry. This meant that companies with higher cost structures showed lower outturns than those with more efficient operations. But it did nothing to expose the differences in underlying security – and still doesn't.

Recently, there have been calls to replace standardised projections with figures based on probabilities of outcome, for example the outturn that is the company's best estimate and the (lower) outturn that has at least an 85% chance of being met or exceeded. This approach may appeal to actuaries, who are comfortable interpreting probabilities. But for typical consumers, who almost invariably aren't, an alternative with the same objective in mind would be for insurers to publish their risk profile on an agreed scale – "adventurous", "balanced", "prudent" for example – and manage themselves accordingly.

This would require closer policing of risk management, which the FSA is already committed to. Good risk management would become a competitive advantage. Failure to manage risk in line with the stated objective should be deemed to be an act of mis-selling.

Savers deserve an informed choice. It's not clear that they have truly had one.

It's the stock market

stupid- part II

At long last, a protection fund for pensions. ***Simon Carne*** *isn't so convinced.*

Let's see if I've got this right. The stock markets crashed to half their value. That put pension funds in deficit. So we're going to be given a Pension Protection Fund in which schemes collectively use their deficits to bail each other out. Something doesn't seem right, somehow. And, of course, it isn't.

Let's not forget that when Robert Maxwell was found to have had his fingers in the pension fund till, there were wide-spread calls for a protection fund to bail out scheme members who fell victim to fraud in future. The Pensions Compensation Board duly followed. At the same time, we were treated to the Minimum Funding Requirement, an arrangement which, ironically, meant that any future fraudsters could be certain that there would be a statutorily determined minimum available if they got tempted.

Now that the MFR has been found wanting, and some pension funds found to be in massive deficit, we are promised a protection fund based on the US model designed to help individual funds caught short when others are healthy.

The simple fact is that, if you want to have a fund that can fall by half and still not be in deficit, you need to have – guess what? – a double-sized fund before the crash starts. Sadly, a variety of legal rulings and surplus regulations made it commercially unattractive to do that. The only other form of protection is a fund that is magically immune to crashes – more of that later.

But for those who don't believe in magic, what is the alternative? Close your eyes and cross your fingers in the hope the markets will go back up? Actually, that's not as daft as it sounds. The whole basis of our economic system is that investors can expect to get a return on their savings. In fact, the riskier the investments, the higher the return investors can expect, provided they avoid over-exposure to individual stocks.

Investing for a long period of time increases the risk – and the potential rewards. Initially, pension funds have money for investment rolling in consistently over many decades. And, when the time comes for paying out, payments are spread out over many decades too. The expected higher returns from equities aren't guaranteed, but if the stock markets cannot deliver for a repeat investor over the long term, it's not just our pensions that are in trouble. The whole world economy would be looking pretty perilous too.

But what about those magical investments that don't go down and up with the equity markets? They're called bonds. They are reputed to match the pension liabilities. For some commentators, including this one, that's a questionable assertion. But the case for bonds certainly got stronger once the government announced legislation to give pension funds a direct claim on solvent employers. In theory, some people say, pension funds should have bought them already, but will start doing so in greater numbers once the Pension Protection Fund gets under way.

But if the markets have been slow to accept the theory thus far, maybe it's because wider considerations are at issue. To turn the theory into practice, companies would buy back their equities en masse and issue debt instead. At the volumes required – around £500 billion (but estimates vary) – it wouldn't be very high quality debt. But then, the government lowered the quality of most of our companies overnight, when it decided to make pension deficits a legal liability on employers. Compared to that, Robert Maxwell wasn't much more than a drop in the ocean.

Actuaries have standards

but whose are they?

***Tom Ross** says it's time for a fundamental change in the way that actuarial standards are set.*

Tom Ross is President of the Faculty of Actuaries

Historically, it has always been actuaries who set the standards of skill, competence and integrity that our members must aspire to. We have taken the view that the people in the best place to know what is achievable and what is unacceptable are senior members of the professional body. But then, perhaps we would say that, wouldn't we? Maybe no longer.

In the mores of the 21st century, it is fundamentally arrogant for actuaries to assume that only we can know what is best for the users of our services. Our advice affects the finances of millions of individuals. They are entitled to have a say in the basis on which we give it. There is also an inescapable conflict in assigning the responsibility for setting standards to the same group of people who apply those standards in a commercial and competitive marketplace.

By the time The Agenda is published, responsibility for the profession's disciplinary scheme will have been devolved to a combination of actuaries who have no part to play on the Councils of the Institute or Faculty and to lay individuals, some selected for us by the legal and accountancy professions. By the end of this year (if not sooner), I would like to see the setting of actuarial standards devolved in a similar way.

We will need to find individuals from outside the profession who have the expertise and the willingness to work with us. But I don't expect they will be hard to find. We will need to persuade them of our intentions. The best way to do that will be to ensure that there are sufficient of them to ensure that they cannot be persuaded out of their views simply by weight of numbers.

There is a danger – whether real or only perceived – that, in order to have some of our standards approved, it has been necessary to achieve a broad consensus amongst our members. Our critics would say this is a recipe for fudge. Whether or not that is right, some of our standards have been too flexible, allowing too wide a range of results. They need re-visiting. All the more so because many of our members place great reliance on the process of peer review. If the standards are inadequate, peer review, at best, is insufficiently challenging and, at worst, endorses inadequate practice.

Too often, perhaps, our standards have allowed through a result which was "not unacceptable," a phrase that, in itself, suggests too cosy a thought process. The same criticism can be levelled at the label – Guidance Notes – given to all of our technical standards, even those which are compulsory.

I don't wish to criticise the generations of actuaries that preceded this one, but I no longer think we can maintain a convincing stance that our standards are issued in the public interest, rather than to protect the profession, if we do not demonstrate their complete integrity. One of the biggest obstacles to that has been the impenetrability of some of our standards. Too often it has been said that, so long as actuaries understand what they mean, that is sufficient. I no longer believe that.

Other professions have demonstrated that externalising the setting of standards is achievable and demonstrably successful. Actuaries must do the same – or else lose our entitlement to say that we aspire to the very highest levels.

The Actuarial Profession

The Institute of Actuaries in England and the Faculty of Actuaries in Scotland are the two professional bodies for UK actuaries. The Faculty and Institute work very closely together as The Actuarial Profession in the UK.

In order to make financial sense of the future, actuaries undergo years of training in mathematics, finance and economics, accompanied by a programme of continuous professional development, so that actuaries remain students as long as they remain actuaries.

The profession aims to:

- innovate by encouraging research and facilitating debate
- educate to promote the benefits of taking actuarial advice
- collaborate with business; regulators; politicians; and other professions and
- regulate – in the public interest, not just our members' interest.

The profession is passionate about identifying matters of public concern where our input and involvement can be of benefit to society. The profession develops robust professional guidance, setting effective standards for actuarial work and a professional code of conduct enforced, where necessary, through disciplinary procedures.

… and its members

Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities – most especially where long term management and planning are critical factors.

The actuary's innovative approach to making business successful is matched by a responsibility and an enthusiasm to provide advice on social and public interest issues. Government has given actuaries a statutory role in the supervision of pension funds and life insurance companies and also to provide actuarial opinions for managing agents at Lloyd's.

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